Statement by Governor - Fifth Bi-monthly Monetary Policy, 2019-20, December 5, 2019

The Monetary Policy Committee (MPC) had discussions during 3rd, 4th and 5th December, 2019. It deliberated extensively on the current and evolving macroeconomic and financial conditions, and the outlook. Based on its considered assessment, the MPC voted unanimously to keep the policy rate unchanged. It, however, decided to continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

2. I express my gratitude to the MPC members for the insightful deliberations and assessment, which went into the policy decision and are captured in the Resolution which has just been released on the RBI's website.

3. I also want to thank our teams in the RBI for their continued high quality support to the MPC's deliberations with their hard work, research and logistics.

4. At the outset, I shall briefly explain the main considerations underlying the MPC's decision. The MPC noted that since its meeting in October 2019, global economic activity has remained subdued, though some signs of resilience are becoming visible. Growth has shown signs of picking up in some advanced economies (AEs) and emerging market economies (EMEs). Crude oil prices have moved in a narrow range in both directions, reflecting the constantly changing sentiments relating to the progress of the US-China trade talks. Inflation has generally remained benign in major AEs and EMEs in Q3 of 2019. Global financial markets were buoyed in October by risk-on sentiment stemming from renewed optimism on a trade truce between the US and China and possibility of a Brexit deal. However, selling pressure took hold in the second half of November on renewed fears of US-China trade talks getting stalled on the Hong Kong stand-off. While the US dollar weakened against other major currencies, EME currencies have been trading with an appreciating bias.

5. Turning to domestic developments, real GDP growth moderated to 4.5 per cent year-on-year (y-o-y) in Q2:2019-20, extending sequential deceleration

to the sixth consecutive quarter. The slowdown in GDP growth was cushioned by a jump in government final consumption expenditure (GFCE). On the supply side, gross value added (GVA) growth decelerated to 4.3 per cent in Q2:2019-20, pulled down by contraction in manufacturing. Growth in the services sector moderated, but agricultural GVA growth increased marginally.

6. Beyond Q2, there are several positive developments which could turn out to be green shoots, depending on how they evolve. *Rabi* sowing is catching up from the setback caused by delay in *kharif* harvesting and unseasonal rainfall in October and early November. By November 29, *rabi* sowing was only 0.5 per cent lower than the acreage covered a year ago. North-east monsoon precipitation was 34 per cent above the long-period average up to December 4. Storage in major reservoirs, the main source of irrigation during the *rabi* season, was at 86 per cent of the full reservoir level as on November 28 as compared with 61 per cent in the same period a year ago.

7. Although there was contraction in output of eight core industries – which constitute 40 per cent of the index of industrial production (IIP) – for the second consecutive month in October, the output of fertilisers rose sharply, reflecting expectations of robust sowing activity in the *rabi* season. Overall business sentiment remained in pessimism in Q3:2019-20; however, the purchasing managers' index (PMI) for manufacturing increased from 50.6 in October to 51.2 in November 2019, driven up by an increase in new orders and output.

8. High frequency indicators suggest that service sector activity generally remained weak in October. However, foreign tourist arrivals posted improvement for the second consecutive month in October 2019. Steel consumption also showed a modest revival on a y-o-y basis in October 2019. There has been steady support to aggregate demand from Union Government expenditure in the month of October 2019. The PMI for services, which had remained in contraction in October (49.2) due to a decline in new export business and turning down of business expectations, moved into expansion zone to 52.7 in November on a pick-up in new business.

9. As regards the external sector, exports contracted in September-October 2019, reflecting the persisting weakness in global trade, but non-oil export growth returned to positive territory in October after a gap of two months. Imports contracted faster than exports and as a result, the trade deficit narrowed in September-October 2019. On the financing side, net foreign direct investment rose to US$ 20.9 billion in H1:2019-20 from US$ 17.0 billion a year ago. Net foreign portfolio investment was of the order of US$ 8.8 billion in April-November 2019 as against net outflows of US$ 14.9 billion in the same period last year. Net investment by FPIs under the voluntary retention route have amounted to US$ 6.3 billion since March 11, 2019. Net disbursals of external commercial borrowings rose to US$ 11.5 billion during April-October 2019 as against US$ 1.2 billion during the same period a year ago. India’s foreign exchange reserves were at US$ 451.7 billion on December 3, 2019 – an increase of US$ 38.8 billion over end-March 2019.

10. Consumer Price Inflation (CPI) increased sharply to 4.6 per cent in October, propelled by a surge in food prices. Fuel group prices remained in deflation, while inflation in CPI excluding food and fuel moderated further from its level a month ago, reflecting the underlying weakness in domestic demand conditions. Survey responses indicate that households’ inflation expectations increased by 120 basis points over the 3-month ahead horizon and 180 basis points over the 1-year ahead horizon as they adapted to the spike in food prices in recent months. Manufacturing firms expect weak demand conditions and reduced input price pressures in Q3:2019-20 and Q4, but they also expect muted output prices reflecting further weakening of pricing power.

11. Taking into account these developments, the MPC revised the CPI inflation projection upwards to 5.1-4.7 per cent for H2:2019-20 and 4.0-3.8 per cent for H1:2020-21, with risks broadly balanced. Real GDP growth for 2019-20 is revised downwards from 6.1 per cent in the October policy to 5.0 per cent – 4.9-5.5 per cent in H2 and 5.9-6.3 per cent for H1:2020-21.

12. The MPC was of the view that economic activity has weakened further and the output gap remains negative. However, several measures already initiated by the Government and the monetary easing undertaken by the Reserve Bank since February 2019 are gradually expected to further feed into the real economy. The impact of external benchmarking of lending rates by banks will further play out in the coming days and months. Inflation is rising in the near-term, but it is likely to moderate below target by Q2: 2020-21. In order to have greater clarity with regard to the overall outlook, the MPC considered it prudent to carefully monitor incoming data. The forthcoming Union Budget will also provide better insight into further measures to be undertaken by the Government and their impact on growth. Against this backdrop, the MPC judged that there is monetary policy space for future action, but felt it appropriate to take a pause at this juncture.

13. Let me now further elaborate on the macroeconomic situation and outlook. First, inflation has indeed risen sharply in November and may remain elevated for a few months. However, the forces driving up inflation appear to be transient. The spike in inflation is essentially due to food prices impacted by unseasonal rains that have caused damage to the standing *kharif* crops. Meanwhile *rabi* sowing is catching up rapidly, and full reservoir levels will provide a cushion against the vagaries of the weather. Therefore, there is a case for looking through the current food price spike, but it would be prudent to await greater clarity on how the inflation path evolves, given the likelihood that several food prices may stabilise by Q4:2019-20.

14. There are also some indications that the capex cycle may be turning up. Unaudited results of 1,539 listed private manufacturing companies suggest that funds mobilised by these corporates during H1:2019-20, including possibly the saving on account of the corporate income tax cut effected in September, were mainly used for fixed assets formation and deleveraging (reduced borrowing). These companies were investing in financial instruments such as investment and loans and advances during the last couple of years in the face of subdued

demand. This shift to investment in fixed assets under the head ‘capital work in progress’ in H1:2019-20 appears to be broad based and even after excluding a few large companies from the sample, the preference for fixed assets is noticeable. Furthermore, pipeline projects sanctioned by banks/financial institutions in the preceding years envisage an expansion in capex spending for the year 2019-20. While these developments are still tentative, they would need to be carefully monitored with incoming data to look out for a durable revival in the capex cycle.

15. Monetary transmission has been full and reasonably swift across various money market segments and the private corporate bond market. As against the cumulative reduction in the policy repo rate by 135 bps during February-October 2019, transmission to various money market and corporate debt market segments ranged from 137 bps (overnight call money market) to 218 bps (3-month CPs of non-banking finance companies). Transmission to the government securities market has been 113 bps for yields on 5-year government securities and 89 bps for yields on 10-year government securities. In the credit market, the 1-year median marginal cost of funds-based lending rate (MCLR) has declined by 49 basis points. The weighted average lending rate (WALR) on fresh rupee loans sanctioned by banks declined by 44 basis points. Going forward, transmission is expected to improve with the introduction of the external benchmark system, as most banks have linked their lending rates to the policy repo rate of the Reserve Bank. Already, the weighted average term deposit rate has fallen by 16 bps. Overall liquidity in the system remains in sizable surplus. This augurs well for transmission to lending rates, going forward.

16. In line with the slowdown in the economy, GST collections so far have fallen below budgeted targets and a similar scenario with regard to direct taxes and customs duty collections can not be ruled out. It is also likely that the Government may initiate some more counter-cyclical fiscal and other measures to arrest the slowdown. The forthcoming Union Budget will provide greater

clarity on all these aspects. At this critical juncture, it is of paramount importance that monetary policy and fiscal policy continue to work in coordination to achieve the best results in the national endeavour to revive growth.

17. The RBI has been pre-emptive in easing monetary policy, with the easing cycle commencing as early as February 2019. Rate reductions have occurred in quick succession in every MPC meeting since then. In its decision today, the MPC has committed to maintaining an accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target. This forward guidance in itself indicates that there is space available for further monetary policy action. However, there is a need to optimise the impact of rate reductions. The key consideration has to be the timing of further actions, even as we monitor the impact of actions already taken so far. It is in this context that the MPC decided to pause for now and evaluate the developments with a readiness to act, if the unfolding situation so warrants.

18. Now, I shall address developmental and regulatory policy measures undertaken for strengthening regulation and supervision, broadening and deepening financial markets, and improving payment and settlement systems.

19. On regulation and supervision, guidelines relating to urban cooperative banks (UCBs) on exposure norms for single and group/interconnected borrowers, promotion of financial inclusion, priority sector lending, and the like would be amended with a view to reducing concentration risk and to further strengthen the role of UCBs in promoting financial inclusion. A draft circular in this regard will be put up in the public domain for stakeholder consultation. These measures are expected to strengthen the resilience and sustainability of UCBs and protect the interest of depositors. UCBs with assets of ₹500 crores and above will be brought under the Central Repository of Information on Large Credits (CRILC) reporting framework to *inter alia* strengthen offsite supervision and early recognition of financial distress. Furthermore, it has been decided to prescribe a comprehensive cyber security framework for the UCBs in a graded

approach. This would bolster cyber security preparedness and ensure that UCBs are brought at par with commercial banks in addressing cyber security threats.

20. A number of commercial banks, urban cooperative banks and other regulated entities are dependent upon third party application service providers for shared services for ATM Switch applications. Accordingly, it has been decided that certain baseline cyber security controls shall be mandated by the regulated entities in their contractual agreements with these service providers. to strengthen the systems.

21. Drawing on the recommendations of the Task Force on Development of Secondary Market for Corporate Loans, the Reserve Bank will facilitate the setting up of a self-regulatory body (SRB) as a first step towards the development of the secondary market for corporate loans. The SRB will be responsible, *inter alia,* for standardising documents, covenants and practices related to secondary market transactions in corporate loans and promoting the growth of the secondary market in line with regulatory objectives.

22. International Financial Service Centre Banking Units (IBUs) will be allowed to open foreign currency current accounts of their corporate borrowers, subject to the provisions of FEMA 1999 and to accept fixed deposits in foreign currency of tenor less than one year from non-bank entities with a view to facilitating ease of operations.

23. The aggregate limits for both borrowers and lenders across all NBFC peer-to-peer (P2P) platforms will be increased from ₹10 lakh to a cap of ₹50 lakh while doing away with the current requirement of escrow accounts to be operated by bank promoted trustee for transfer of funds having to be necessarily opened with the concerned bank. This will provide more flexibility in operations.

24. ‘On tap’ Licensing Guidelines for Small Finance Banks are being issued today.

25. As regards financial markets, after due stakeholder consultations, certain changes are being effected in foreign exchange hedging facilities. Users may undertake over the counter (OTC) currency derivative transactions up to USD 10 million, without the need to evidence underlying exposure. Banks shall be provided with the discretion, in exceptional circumstances, to pass on net gains on hedge transactions booked on anticipated exposures. Safeguards will be strengthened to ensure that complex derivatives are sold only to users that are capable of managing the risks.

26. Finally, in the area of payment and settlement, Prepaid Payment Instruments (PPIs) have been playing an important role in promoting digital payments. To further facilitate PPI usage, it is proposed to introduce a new type of PPI which can be used only for purchase of goods and services up to a limit of ₹10,000. The loading / reloading of such PPI will be only from a bank account and they shall be used for making only digital payments.
